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E.O. 12958: N/A
TAGS: ECON EFIN EINV BR
SUBJECT: BRAZILIAN ECONOMY SHOWING FIRST SIGNS OF RECOVERY

REF: A. Brasilia 0141; B. Sao Paulo 070

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Brazil increasingly appears to be in a state of early economic expansion. Recent market and sentiment indicators have shown improvement. More importantly, contacts have started speaking with much greater optimism about Brazil's outlook and their willingness to take risk than even one month ago. Key factors underlying Brazil's cyclical improvement include recent gains in commodity prices, a rapid reduction in inventories, and stronger consumer confidence. While lending activity is improving, banks remain conservative. Credit conditions, however, are more of a lagging indicator of Brazil's cycle than they are a leading indicator of where Brazil's economy is headed. As Brazil starts to recover, key questions include the speed of its recovery, potential risks to its recovery, and the extent to which Brazil's recovery moves in sync with the global economy. Although the base-case scenario remains that that Brazil's recovery will be gradual, a growing minority of Brazilians believe that a more rapid recovery is plausible. Most Brazilians believe that current downside risks are low and that Brazil, in contrast to past recessions, is now leading the global economic cycle rather than following it. End Summary.

Brazil's Nascent Recovery

¶2. (SBU) Like several other economies around the world, Brazil's economy has shown signs of improvement in recent weeks. Quantitative variables that point to an upswing include a 10 percent recent decline in bank spreads, substantial exchange rate appreciation (nine percent over the past month), stronger sales and spending data, and a jump in the volume of capital market activity. Over the past quarter, the number of consumers who report optimism about Brazil's economic prospects over the next six months has risen by nearly 10 percent. Business confidence has also risen sharply over the past month. While exuberance would be misplaced, Brazil now clearly appears to be in an early stage of cyclical expansion.

¶3. (SBU) Qualitative indicators also suggest that Brazil is now in an early recovery. In contrast to the gloom almost universally prevalent in recent months, bankers and businessmen speak with increasing optimism about Brazil's growth and investment outlook. Riskier assets are regaining their popularity. Asset managers

report that alternative investment markets are unfreezing. Market expectations of large central bank rate cuts in upcoming COPOM meetings are being gradually (though not entirely) scaled back. The possibility that Brazil may be growing close to its potential growth rate (3.5 percent) by the fourth quarter seems plausible. Downside scenarios are increasingly hard to imagine.

¶4. (SBU) Recent improvements, however, are not reflected in Brazil's 2009 growth forecasts. Rather than being upgraded, 2009 growth forecasts have actually been revised down in recent weeks (to a 0.53 percent contraction). This anomaly is explained in large part by GDP arithmetic. Because the contraction in the first quarter was sharper and deeper than originally forecast, Brazil's recovery is starting from a lower baseline. Even as quarterly growth accelerates, strong second half growth is therefore unlikely to lift Brazil's annual GDP growth figure this year into positive territory.

Explaining the Recovery

¶5. (SUB) Three factors underlie Brazil's recent inflection: (1) stronger commodity prices, (2) a rapid inventory correction, and (3) a rise in domestic confidence. Improvements in these variables have in turn helped to ease local credit conditions. The pace of credit growth rose last month following five consecutive months of decline. Complaints that banks are rationing credit have fallen significantly since the first quarter. Despite this improvement, banks do not yet appear to be playing a central role in Brazil's recovery. Credit conditions are improving, though rates remain above pre-crisis levels. Consumer defaults declined last month

after peaking in March (8.4 percent). Among businesses, however, defaults continue to rise (2.6 percent in March, 2.9 percent in April). Credit portfolios remain conservative. Lending behavior is more of a lagging than a leading indicator of Brazil's cycle.

¶6. (SBU) Stronger commodities are one factor supporting Brazil's recovery; however, the direct impact on Brazil's macroeconomic accounts is not decisive. Over the past quarter, futures prices for metals, soy, sugar, and coffee are 20 to 30 percent higher. Much of this increase stems from upward revisions in China's outlook, which recently became Brazil's largest export market and where purchases of Brazilian iron and agriculture products are rising rapidly. Indeed, Brazilian economists track China's economic outlook almost as closely as the U.S. outlook. Although commodities represent roughly one-third of Brazil's exports, they also account for a similar share of imports. The net effect commodity prices have on Brazil's trade accounts is thus fairly neutral. Brazil's financial account is more closely linked to commodities, with roughly one-third of recent FDI inflows directed to the commodity sector. Brazil's fiscal accounts are affected positively, though indirectly, by higher commodity prices since most commodity firms are privately owned.

¶7. (SBU) Commodities prices are nonetheless a closely watched indicator, particularly because the commodities sector is investment-intensive. Higher prices can thus be a useful leading indicator of future investment demand. Another reason is that Brazil's Bovespa has a large weighting of commodity firms - Petrobras, Vale, and Gerdau are Brazilian flagships and key barometers of local conditions. Commodity gains have helped boost share prices, which is strengthening balance sheets as well as confidence and spending propensity more broadly. The Bovespa is 16 percent higher over the past month.

¶8. (SBU) A second factor supporting Brazil's recovery has been a reduction in inventories. Rapid inventory reductions have been due in part to specific actions taken by Brazil's government - most notably, the production tax (IPI) reduction in January that stimulated car sales and helped dealers to eliminate excess inventories in less than three months (Ref A). More important, however, has been the ability of Brazilian firms to quickly adjust their production and cost structures once stockpiles began to build. In the last quarter of 2008 and the first quarter this year, local

production virtually froze. The result was a swift, steep drop in output that hurt GDP in the near-term (contractions of 3.0 percent and 3.1 percent, respectively) but was a necessary supply response in the absence of signs of a recovery in demand. The speed with which Brazil's firms responded to reflects their flexibility - an interesting contrast given that Brazil often scores poorly in cross-country rankings of business conditions (e.g., the World Bank's Doing Business indicators).

¶9. (SBU) Because total demand in Brazil is strongly weighted toward private consumption (60 percent), even minor changes in household expenditures can have large ripple effects. Brazilian consumers are not heavily indebted, they invest most of their savings in bank deposits (hurting returns and wealth in expansions but also stabilizing household balance sheets in downturns), and Brazil's labor market has weakened but generally held up better than initially expected. Rather than fighting cost reductions, many labor unions have proactively agreed to unpaid vacations and part-time work to help limit job losses (Ref B). In contrast to past recessions (1983, 1999), Brazil's poverty rate has declined in this recession, helping to prevent a complete collapse in spending among poorer groups.

Confidence Most Important Factor

¶10. (SBU) While perhaps the hardest variable to predict, changes in confidence are probably the most important factor driving Brazil's economic cycle at this stage. Brazil now has greater space for fiscal and monetary expansion. Compared to previous recessions, when rates were tightened and spending reduced, Brazil now has room for counter-cyclical policies for the first time in its recent

history. Some Brazilian economists call this difference the "game changer" that has fundamentally separated Brazil's response in this crisis from past downturns. Therefore, Brazil's current recession is more about psychology than its own vulnerabilities or economic imbalances. From the outset of the crisis, Brazil had ample liquidity, strong banks, solid macroeconomic accounts, and little reason to worry about its own financial collapse. Instead, the main source of problems has been negative psychology more than it was a cash flow crunch or need for balance sheet restructuring. Whereas psychology was working against Brazil in recent months, however, it now seems increasingly likely to work in its favor over the next several quarters.

Comment: Remaining Recovery Issues

¶11. (SBU) While uncertainties remain, a limited data series now exists suggesting that Brazil may be at a very early stage of economic expansion. More importantly, a tone of cautious optimism is now palpable in Brazil that was completely absent even one month ago. As Brazil starts to grow again, three issues are worth watching. The first issue concerns factors that might derail Brazil's recovery. While a reversal is always possible, the greater likelihood is that Brazil's recovery will endure because its fundamentals remain sound and local sentiment is improving. Likewise, the speed with which Brazil's recovery will occur also merits attention. Although a slow recovery remains the base-case scenario, a growing minority of contacts believe a more rapid recovery is plausible given that Brazil's current production is significantly below the total of its production capacity. The third issue is the link between Brazil's recovery and the global recovery. In contrast to past recessions, Brazil's economy now appears to be leading the global cycle rather than trailing it. For the first time in its recent history, Brazil may become an engine for economic recovery. End Comment.

¶12. (U) This cable was drafted with the Treasury Financial Attache and coordinated/cleared by Embassy Brasilia.

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